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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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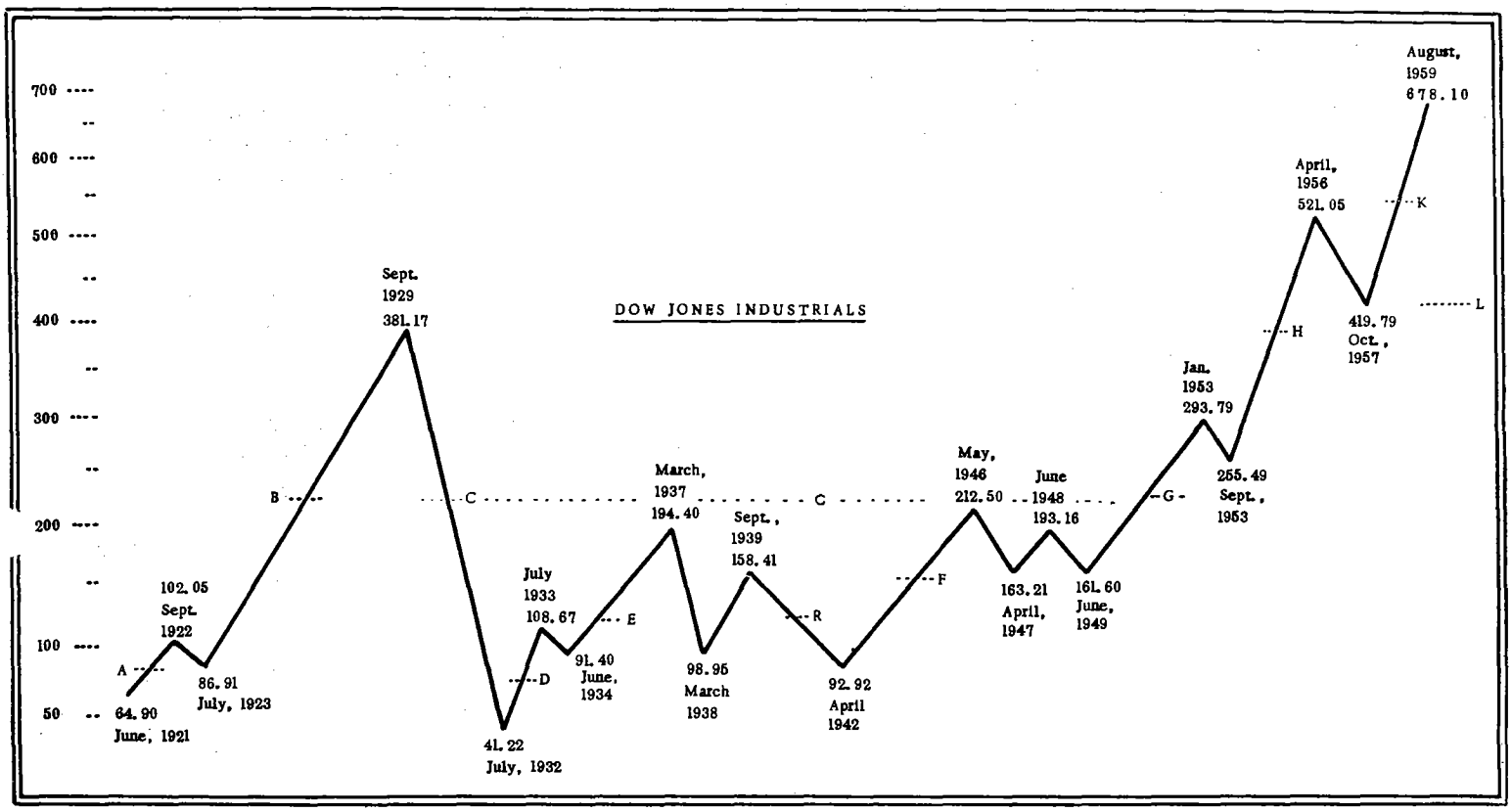
SPECIAL STUDY - - DOW'S 50% PRINCIPLE



Charles H. Dow had always been fascinated by the movements of the market and the relationship of those movements to the actual laws of physics. Among the most important and least-known of Dow's contributions to market knowledge is his work on "the great law of action and reaction". In his Wall Street Journal editorial of July 7, 1900, Dow presented a far-reaching thesis, the crux of which appears below:

> "It is a remarkable fact in speculation that both the average price of a number of stocks and the price of individual stocks show strong tendencies, both in rallies and relapses to reach one-half of the primary movement. When a stock falls ten points in a comparatively direct movement, it is extremely likely to rally as much as five points from the lowest. It often rallies or relapses more than half of the original swing, but it is generally safe to wait for about half.

> A comparison of the Averages...shows how regularly this movement occurs. When a recovery does not come near being one-half of a decline, it generally means that the primary movement has not been completed and that a new low quotation will be made."

For want of a better name, Dow's thesis might be termed the 50% principle. The entire 50% concept has interested me greatly, and I have studied it for many years. It seems to me that the principle can best be understood if it is compared to the action of a scale or balance. Referring to the scale in the illustration, if the left end of the beam (marked A) is forced up from its resting position then the beam will approach the horizontal position or 50% level (dotted position B). If the upward thrust has been great enough, the beam will swing all the way up to the high position (dotted position C). But if the upward thrust from A was insufficient, the beam may approach or touch the 50% level (B), falter, and then sink back to the original position at A. I have outlined four conclusions which are implicit in Dow's 50% principle as I understand it:

(1) Following a major market advance, if, on the subsequent correction, the (Industrial) Average holds persistently above the halfway (50%) level, the odds favor the highs' again being approached (or bettered).

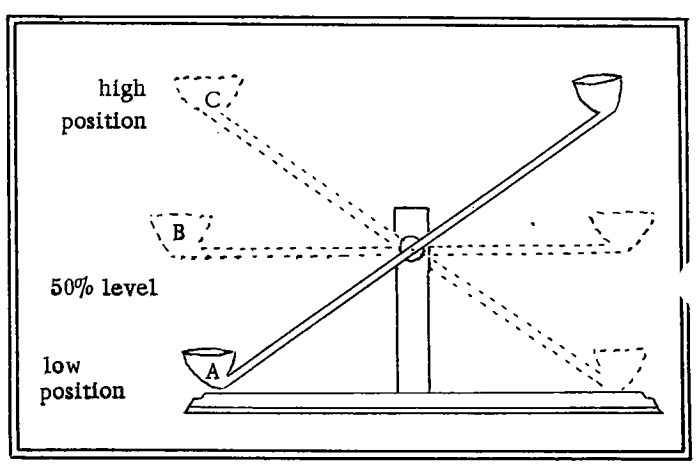
(2) Conversely, following a major advance, if the subsequent retracement or correction goes below the 50% level the primary direction can be considered to have turned down. The preceding lows may then be approached (or passed).

(3) Following a bear market, if a bull market succeeds in retracing 50% or more of the previous bear market losses, the odds then favor the new bull market's approaching or bettering the old bull market high.

(4) Following a bull market, if the next bear market succeeds in erasing more than 50% of the total bull market gains, the odds then favor the bear market's testing the old bull market low.

The accompanying chart traces the major swings of the D-J Industrial Average from 1921 to the present. An analysis of this period should help to clarify the implications of Dow's 50% principle.

In June, 1921, a bull market began at 64.90 (Industrial Average). By September, 1922, the Average had risen to 102.05. A reaction ensued, and many observers believed this reaction to be a bear market. It is interesting to note, however, that the decline to 86.91 (July, 1923), held above point A (83.47), the halfway mark between 64.90 and 102.05. Because the Average refused to retrace more than 50% of the preceding major swing, Dow's 50% principle pointed to the probability of the upmove's continuing. This is exactly what occurred, and the advance from 1923 to 1929 was one of the most explosive and spectacular movements in market history. The great bull market terminated on September 3, 1929, at 381.17.



The "Crash" of 1929 broke below point B (223.03) in November, 1929. Point B represented the halfway mark between 64.90, the starting level in 1921, and 381.17, the peak in 1929. Because the market pendulum broke below the 50% level of the entire preceding bull market advance, Dow's 50% principle suggested that the 64.90 of 1921 might be approached or tested. The incredible bear market bottom (41.22) of July 8, 1932, not only approached the 1921 point but actually went below it.

In July, 1932 at 41.22 a new bull market started. An explosive rise took Industrials to 108.67 in July, 1933. An extended secondary reaction followed, which returned the Average to 91.40 in June, 1934. The 50% mark between 41.22 and 108.67 was at D (74.84), and this level was not violated. The failure of Industrials to break the 50% level implied that the primary trend continued up. Subsequently, the bull market advanced to 194.40 (March, 1937).

The 1937-38 bear market violated point E (117.81), which was the halfway mark between 41.22 and 194.40. Because of this, Dow's 50% principle suggested the possibility of a test of 41.22. The 41.22 bottom of July 8,1932, represented the extreme low point of the worst bear market in history, however, and (happily) that depressed level was not approached too closely. Nevertheless, in the brief period between 1937 and 1938 Industrials lost 49.1% of their total value; the bear market hit bottom at 98.95.

From March, 1938 to September, 1939, an insignificant bull swing occurred, and this was followed by an extended bear market which broke below the halfway point between 98.95 and 158.41. That action implied a testing of 98.95, and, in fact, the 1939-42 bear market bottomed out at 92.92 in April, 1942.

When the bull market which began in 1942 bettered the 50% level of the preceding 1939-42 bear market (R - 128.68), the implication under the 50% principle was that Industrials would approach the 1939 high of 158.41. The 1939 high (158.41) was not only approached -- it was bettered, and the bull market continued to 212.50 (May, 1946).

The bear market which started in May, 1946, touched bottom in April, 1947, at 163.21. 163.21 was well above F (152.71), the halfway point of the entire 1942-46 bull market. Here for the first time since 1899-1900, a bear market persistently refused to erase at least 50% of the preceding bull market. If the Average continued to hold above F, the implication was that the 1946 bull market top at 212.50 would again be approached. A baby bull market began in April, 1947; it ended in June, 1948 at 193.16. Again Industrials turned down, and again the market bottomed above F, this time at 161.60 in June, 1949. The refusal of the Industrials to violate the F level over a three year period was extremely bullish under Dow's 50% principle.

On June 13, 1949, a new bull market was born at 161.60, and the average began a steady and relentless advance. In mid-1950 an event of far-reaching importance occurred. Here, for the first time since 1932, a new bull market succeeded in hurdling the 50% level (C - 211.20) between the 1929 high (381.17) and the 1932 low (41.22). Rule number 3 now came to the fore. Dow's 50% principle was saying (1) that the market pendulum had finally swung decisively above the halfway point of the 1929-32 range, and (2) that the movement above C had occurred within a healthy new bull market. Remember, in 1937 an aging bull market had "topped out" just 16.80 points below C; in 1946 an aging bull market had topped out exactly 1.30

points above C. But the 1949-53 swing had hurdled the C level during an advance which displayed every sign of being part of a healthy new bull market. Under the 50% principle, the odds now favored the new bull market's approaching or bettering the 1929 high of 381.17. At the time such an event seemed inconceivable.

The first massive swing of the bull market which began in 1949 hit a peak at 293.79 in January, 1953. From there a severe reaction took place. Despite the fact that the bull market had not exhibited any of the characteristics usually associated with bull market tops, many observers called the reaction a "bear market". The reaction hit bottom in September, 1953 at 255.49, a point which was well above the halfway mark (G - 227.69) of the 1949-53 advance. In holding above the G point, Dow's 50% principle was saying that the odds favored the market's approaching or bettering the 293.79 high.

A second broad advance got under way, taking Industrials to 521.05 in April, 1956. The extended and complex reaction which followed brought out a new "bear market" chorus, but the October, 1957, reaction low of 419.79 held well above the 50% level (H - 388.27) of the 1953-56 advance. Furthermore, bull market top characteristics had again failed to appear. The market surged forward once more, and the subsequent 1957-59 rise hit a peak of 678.10 in August, 1959. Here for the first time the bull market top characteristics of low yields, high volume, rampant speculation and wide crowd participation were present. In January, 1960, the Average turned down, and in March, 1960, a bear signal was given.

All of which brings us to the present. So far, the 50% level of the 1957-59 advance (K - 548.94) has not been approached. If Industrials eventually violate K the 50% principle will suggest a testing of the halfway mark (L - 419.85) of the entire 1949-59 bull market advance. If L is broken the market pendulum could approach or test the extreme low level of 1949 (161.60). The L level (perhaps coincidentally) assumes a double significance since (1) L represents the halfway mark between the bull market extremes of 161.60 and 678.10, and (2) L is 6¢ above the low point of the 1957 reaction (419.79).

The converse of the foregoing is as follows: under the 50% principle a persistent refusal of Industrials to violate K (548.94) or L (419.85) could signify that (1) a change in the primary trend was taking place, or (2) a relatively mild bear market had run its course.

QUESTION Isn't the 50% principle at variance with that principle of Dow's Theory which states that neither the duration nor extent of a primary swing (or a bull or bear market) can be predicted in advance?

ANSWER In a strict sense -- yes. But a careful reading of Dow's work suggests that he took note of what the market did at 50% levels. I do not regard the 50% principle as a predictive device; I see it more as an empirical law such as the law (or observation) which suggests that secondary reactions tend to correct 1/3 to 2/3 of the preceding primary movement.

QUESTION The 1949-59 bull market has been the longest and certainly one of the greatest bull markets in history. In view of this and the possible drastic correction (bear market) which could follow, suppose the current bear market persistently holds above the K or L levels?

ANSWER If this proves to be the case I will be the first to judge the movement in the light of the 50% principle. Regardless of what one may expect as to the length or duration of a bear (or bull) market, the quickest way to go wrong is to dogmatize (or to refuse to believe what is happening).

(September 5, 1960)